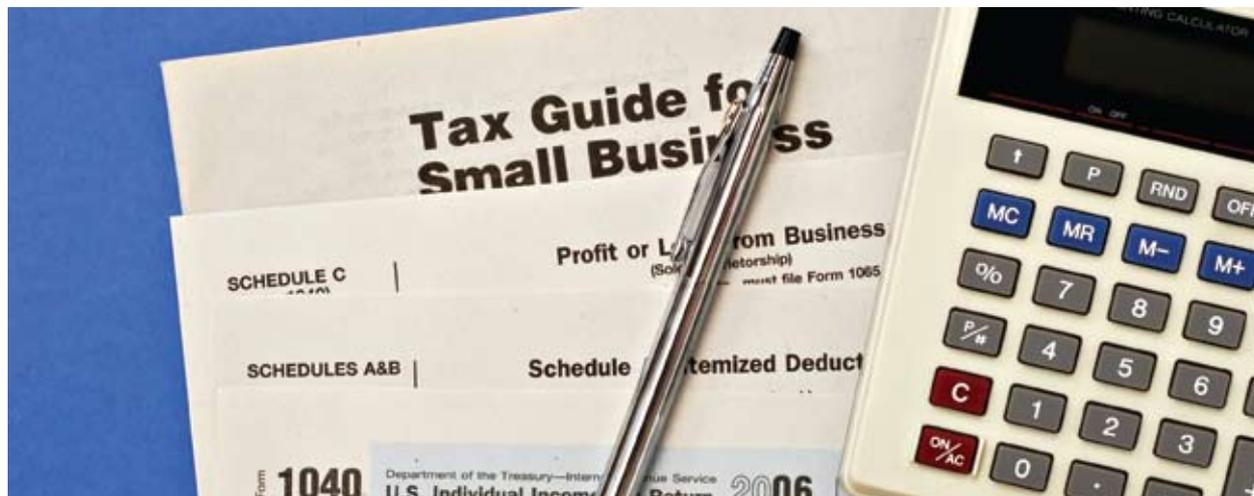


An Insight into Advance Pricing Agreements



Amid raging debates on the proposed Direct Tax Code, our Finance Minister has recently promised that the Code would be brought into effect by 1st April, 2012. As the promised deadline closes, apprehensions are being expressed about some new concepts that the Code proposes to implement. A new tax scheme has been proposed in India in the form of the Direct Tax Code. Vide section 118 of this code, a new scheme of Advance Pricing Agreement/Arrangements (APA) has been brought about to be implemented. The objective of an APA is to deliver certainty, for both the taxpayer and the tax authorities, of the tax outcomes of the taxpayer's international transactions by agreeing in advance the arm's length pricing methodologies to apply to the taxpayer's international transactions covered by the APA. For a taxpayer, an APA can be an effective tool for better managing the tax risks arising from international transactions. For tax authorities, an APA can similarly be an effective tool for better and more efficient administration of the transfer pricing laws. With a new challenge, always comes a new opportunity. Let us now try understanding and taming this new concept of APAs.

Finance Minister Mr. Pranab Mukherjee recently promised that the Direct Tax Code would be brought into effect in India by 1st April, 2012. With this promise, comes an apprehension, more so, in the new concepts that the DTC proposes to implement such as Controlled Foreign Companies (CFCs), Advance Pricing Agreements/ arrangements (APAs), etc. Let us hereby try and tame one such concept of APAs.

What is an APA

Cross border transactions have increased enormously over the years. With this increase in transactions, there have been increasing instances of international tax avoidance, leading and culminating to a sharp rise

in litigation. It has always been the agenda of the Finance Ministry to reduce the increased litigation in India. And to address the same, several measures have been taken by the Ministry like, increasing the monetary limits for filing the appeal, new legislations like GST/ DTC, etc.

The Income-tax Act, 1961 has a provision for Safe Harbour Rules in respect of Transfer Pricing (TP) tax issues, inserted effective April, 2009 which indicate that the Board may make rules for notifying circumstances to accept the Transfer Price declared by the assessee. In 2010, CBDT has constituted a Committee to formulate rules for Safe Harbour provisions which is being chaired by the Director General of International



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Tax and comprising senior tax officers and members of Trade and Industry and also the members of the Institute of Chartered Accountants of India.

As of now, TP tax provisions are rather rigid. Without any threshold limits on quantum, Form 3CEB is to be filed by an assessee who has had even one international transaction with an Associated Enterprise. If the quantum goes beyond INR 10 million, mandatory requirement of having a detailed documentation is prescribed. If the transactions aggregate to ₹150 million, compulsory scrutiny is mandated. In this backdrop, safe harbour rules would perhaps provide some respite to some smaller assessee coming under TP net.

Also, we may have to see about the much talked APA provision (Advance Pricing Agreements), a system that has been universally present in various evolved tax regimes in the world and the one that has now been contemplated in the Direct Tax Code is implemented and accepted in India.

An Advance Pricing Agreement/ arrangement (APA) offers a way to secure tax authority approval of your transfer pricing policies and methodologies for up to five years in advance. It is a framework for the tax administration and a taxpayer to agree that, provided the taxpayer files its tax return in accordance with the agreed APA conditions for the APA covered years, the tax administration accepts the tax outcomes as being consistent with arm's length outcomes, and thereby refrains from auditing the taxpayer's international transaction(s) covered by the APA.

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apply to the taxpayer's international transactions covered by the APA. An APA may thus, remove an audit threat (eliminate the need for an audit), deliver a particular tax outcome based on the terms of the agreement, and often substantially reduces compliance costs over the term of the APA. This enables a more efficient and effective management of transfer pricing compliance requirements by bringing fairness, simplicity and efficiency, which may otherwise lead to protracted and disputed dealings between a taxpayer and the tax authorities, including difficulties involved in resolving economic double taxation.

Thus, for a taxpayer, an APA can be an effective tool for better managing the tax risks arising from international transactions. For tax authorities, an APA can similarly be an effective tool for better and more efficient administration of the transfer pricing laws.

Consequently, APAs provide a win-win situation for all the parties involved.

APAs are in fact a measure designed to facilitate compliance with the transfer pricing rules and do not impose any further tax liability on a taxpayer.

History of APAs

The concept of APAs started with Japan introducing a system called Pre Confirmation System (PCS), in 1987, which happens to be a unilateral APA process. Further, in 1988, the US Treasury Department issued a white paper titled "A Study of Intercompany Pricing" which set the stage for an APA Program in the US. The US finally began its own APA programme in 1991. It used APA as an effective tool to reduce administrative burden and also, to provide a predictability of transfer pricing methodology. Several countries followed suit. In the 1990s,

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countries such as Canada, Australia and the UK adopted the concept of APA. The OECD issued a set of APA Guidelines in 1999. Late, but nevertheless, India too chooses now to wake up and introduce APAs.

Types of APAs

1. **Unilateral** – APA between taxpayer & tax authority of domestic country. This agreement is likely to be entered into when a party is in a jurisdiction where no treaty is available.
2. **Bilateral** – APA between two tax authorities in respect of transactions involving taxpayers in both jurisdictions. This agreement provides full protection from double taxation. When such agreements are possible, revenue authorities generally avoid entering into multiple unilateral agreements.
3. **Multilateral** - APA between taxpayer and multiple tax



authorities. Here, three or more governments are involved. Such agreements are uncommon since it is generally very complicated and intricate to get multiple tax authorities to agree upon it. Thus, such agreements are generally struck only when such transactions are so linked that they cannot be separately tested.

4. **Synthetic Bilateral** – This agreement is used when no bilateral APA is possible because no tax treaty exists, or where a tax treaty exists, but one of the tax authorities do not have an APA experience or ability.

Some countries allow for unilateral arrangements where the tax administration and the taxpayer meet and finalise an arrangement. A unilateral APA, however, may affect the tax liability of associated enterprises in other tax jurisdictions.

Where unilateral APAs are permitted, the competent authorities of other interested jurisdictions should be given an option to determine whether they are willing and able to consider a bilateral arrangement under the mutual agreement procedure. In any event, countries should not include in any unilateral APA, concluded with a taxpayer, a requirement that the taxpayer waives access to the mutual agreement procedure if a transfer pricing dispute arises. Also, if another country raises a

transfer pricing adjustment with respect to a transaction or issue covered by the unilateral APA, the first country is encouraged to consider the appropriateness of a corresponding adjustment and not to view the unilateral APA as an irreversible settlement. When appropriate, the competent authorities may enter into a Bilateral APA or Multilateral APA with its foreign counterparts under the Mutual Agreement Procedure (MAP) article of the relevant income tax treaty.

Benefits of APA

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The primary advantage of an APA is the approval of the transfer pricing methodology (TPM), which can be not only a traditional methodology, such as comparable profits method or resale price method, but also any other method described in the regulations, a combination of methods or a concoction of mutually agreed formulae.

The advance acceptance affords the taxpayer the knowledge that no adjustment will result if the agreement is followed. It spares the taxpayer the ordeal of a detailed audit to verify the appropriateness of the TPM used in transactions.

Besides, other advantages would be an efficient resolution of otherwise recurring complex appellate issues, minimisation of global risk, freedom from preparing annual transfer pricing documentation, etc.

Coverage of APA

An APA would ideally cover following areas:

- Name and preliminary details of the entities involved.
- Functions and risk profiles of the

applicant, including eligibility criterion.

- Nature of international transactions entered into.
- Confidentiality.
- Transfer Pricing methodology to be applied.
- Duration for which the arrangement would hold true and valid.
- Compliances to be adhered to
- Criterion involving reviews, submissions, etc.
- Fees.
- Consequences of an APA.
- Public reporting.
- Any other matter with regards to the facts of the case.

Stages in APA Process

- i. **Feasibility Study:** An APA is not suitable for everyone and for every situation. Thus, a feasibility study needs to be undertaken, with a precise and detailed thought to the acceptable risk tolerance benchmarks, and the clearly comprehended risks and benefits involved.
- ii. **Pre-filing conferences:** This would allow taxpayers to discuss the suitability of an APA before deciding to pursue it. Pre-filing conferences can be held on a named or anonymous basis also. Particularly in the beginning of the programme, it would be useful if taxpayers are given an opportunity to meet the Board personnel, who will process their case. This will help build trust in the process. In particular, offering anonymous pre-filing conferences provides taxpayers the opportunity to determine the receptivity of the Board to the issues in its particular case without fear of inviting an audit or identifying possible areas of audit, should the taxpayer decide not to proceed with an APA.
- iii. **APA Application:** An APA application should contain

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enough information to properly evaluate the arm's length nature of the proposed transactions. This would comprise in depth detail of history of business operations, worldwide organisational structure, ownership, capitalisation, financial arrangements, principal businesses, locations of the business and major transaction flows, covered transactions, their value and how they relate to any company transactions not covered under the APA, detailed analysis of the functions of each party involved, and economic activities performed, the assets employed, the economic costs incurred, the risks assumed, relevant contractual terms, relevant economic conditions.

- iv. **APA Due Diligence:** Tax authority due diligence generally comprises reviewing the taxpayer's submissions, and thereon conducting meeting with the latter over concerns raised. Further, a case management plan may also be strategised with specified milestones during the review process.
- v. **Case Processing:** The revenue will need to determine who

will process APAs, evaluate the taxpayers' position and negotiate on behalf of the former. The Board may choose to disclose this information to the public or not. Thus, the revenue will hereby determine who will primarily be responsible for this compliance verification. It may be useful to offer this role to the officer having jurisdiction in auditing the taxpayer. This due diligence phase is followed by negotiation of the APA. For unilateral APAs, the tax authority will arrange negotiations and discussions with the enterprise after the tax authority reaches a position following its examination and evaluation process. For bi-lateral or multilateral APAs, negotiations and discussions with the relevant competent authorities will be arranged on the basis of the relevant information provided.

- vi. **Compliance Reporting:** The Board needs to frame guidelines to establish procedures to administer the APA and to verify a taxpayer's compliance with its terms. Most governments use a report, if led annually and evidencing compliance in each year of the APA to assure compliance. The revenue should determine who will be primarily responsible for this compliance verification. It may be useful to offer this role to the field office that would have had jurisdiction in auditing the taxpayer.
- vii. **Termination of an APA:** Under some circumstances, it may be necessary to terminate an agreement. Many governments distinctly spell out some of those circumstances. In the case of fraud or failure to disclose material information, the revenue could take the position that the APA was void *ab initio*

and, therefore, a taxpayer would be subject to audit for the years in question.

viii. **Rollbacks:** The Board will need to consider whether providing a rollback mechanism at the start of the Indian APA Programme is in the best interest of the Government and taxpayers. While a rollback mechanism can resolve pre-APA years and, therefore, improve efficacy of the process, the rules and objectives related to conducting tax audits would need to be reconciled with the rules and objectives of an APA programme, which essentially are to be flexible in setting standards for prospective evaluation of a taxpayer's transfer pricing treatment of covered transactions.

ix. **APA Renewals:** It may be appreciated that taxpayers may wish to roll forward, or renew, existing APAs particularly when the facts and circumstances surrounding the covered transactions have not changed materially. In such case, it may

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vide Section 118. The DTC pronounces that the advance pricing agreement is to have an advance arrangement of determination of controlled transactions based on certain appropriate criteria having regard to future critical assumptions for determining the transfer pricing over a fixed period of time.

be possible to use streamlined procedures to expedite processing.

India's Story

India is taking its first baby step on APAs via its proposed Direct Tax Code (DTC), vide Section 118, the DTC pronounces the following:

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ing regard to future critical assumptions for determining the transfer pricing over a fixed period of time.

- The DTC proposes to provide a mechanism and empowers the Central Board of Direct Taxes to formulate a scheme for introducing the advance pricing agreement.
- Taxpayer could approach the Central Board of Direct Taxes (CBDT) for determining the arm's length price fixation for international transactions to be entered into.
- The Central Board of Direct Taxes could determine the arm's length price under the advance pricing agreement having regard to transfer pricing regulations – the CBDT is also empowered to make necessary adjustments having regard to the international transactions.
- The determined advance price agreement is binding between the taxpayer and the regulator in respect of the advance price agreement entered into.
- The advance price agreement would be valid for the specified period agreed to subject to maximum of five consecutive financial years. The same also could remain in force till such time that there are no changes in the law on the basis of which the advance pricing agreement is entered into.
- The APA would stand voidable in a case involving fraud or misrepresentation.

Conclusion

With the benefits APAs have to offer, India would do well with the certainty and clarity of opinion that it brings along. Countries globally have accepted APAs to smoothly meet compliance requirements, and now it's time that India takes a stride into this arena. ■

